STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	**5/1/02**	Bill No:	**SB 1662**
Tax:	**Property** **Sales and Use Tax**	Author:	**Peace**
Board Position:		Related Bills:	**AB 1013 (2001)** **AB 2288 (2000)** **SB 82 (1991)** **Proposition 167 (1992)** **AB 680 (Steinberg)** **AB 2878 (Wiggins)**

BILL SUMMARY

This bill would, with respect to Board-administered taxes, state legislative intent to enact legislation:

(1) To provide a more stable revenue structure that may include:

- Requiring the reassessment of nonresidential property when cumulatively more than 50% of the ownership has been transferred and
- Broadening the state and local sales and use tax base and reduce both the state and local sales and use tax rate.

(2) To develop a more rational allocation of revenues for the state and local agencies, including cities, counties, special districts, and school districts, for purposes of reducing volatility at the state and local level and to provide incentives for economic development and housing.

ANALYSIS

Current Law

Under existing **property tax law**, real property is reassessed to its current fair market value whenever there is a "change in ownership." (*Article XIIIA, Sec. 2; Revenue and Taxation Code Sections 60 - 69.7)*

Revenue and Taxation Code Section 64 sets forth the change in ownership provisions related to the purchase or transfer of <u>ownership interests **in** legal entities</u> that own real property. Generally, when real property is owned by a legal entity, the purchase or transfer of ownership interests in that legal entity does not trigger a change in ownership of the property. An exception to this general rule is when there is a "change in control" of the legal entity. Subdivision (c) of Section 64 generally provides

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that a "change in control" occurs when any person or legal entity acquires **more than 50 percent** of the ownership interests in the legal entity.

Under existing **sales and use tax law**, the sales or use tax is imposed on the sale or use of tangible personal property within this state. The sales and use tax rate is made up of the following components:

- 5 percent state tax allocated to the state's General Fund (Section 6051, 6051.3, 6201 and 6201.3).
- 1/2 percent state tax allocated to the Local Revenue Fund which is dedicated to local government for program realignment (Section 6051.2 and Section 6201.2)
- 1/2 percent state tax allocated to the Local Public Safety Fund which is dedicated to local governments to fund public safety services (Sec. 35 of Article XIII of the California Constitution).
- 1 1/4 percent Bradley-Burns Uniform Local Sales and Use Tax which is allocated to cities and counties (Part 1.5, commencing with Section 7200).
- 1/8 to 1 1/4 percent Transactions and Use Tax which is allocated to special taxing jurisdictions in various counties and cities within the state (Part 1.6, commencing with Section 7252).

The Bradley-Burns Uniform Local Sales and Use Tax Law (commencing with Section 7200 of the Revenue and Taxation Code) authorizes counties to impose a local sales and use tax. The rate of tax is fixed at 1¼ percent of the sales price of tangible personal property sold at retail in the county, or purchased outside the county for use in the county. All counties within California have adopted ordinances under the terms of the Bradley-Burns Law.

Under the Bradley-Burns Law, the ¼ percent tax rate is earmarked for county transportation purposes, and 1 percent may be used for general purposes. Cities are authorized to impose a sales and use tax rate of up to 1 percent, which is credited against the county rate so that the combined local tax rate under the Bradley-Burns Law does not exceed 1¼ percent.

The 1¼ percent tax is collected by the Board, primarily from remittances by retailers. The Board currently allocates the tax to cities and counties primarily based on the retailer's place of business (i.e., situs method of allocation).

Proposed Law

This bill would state that is the intent of the Legislature to:

1. "[A]mend the Revenue and Taxation Code to provide a more stable revenue structure that may include changes such as a reduction in the personal income tax rate on capital gains, broadening of the state and local sales and use tax base, reducing both the state and local sales and use tax rate, and providing that change of ownership for nonresidential property shall result in reassessment when a cumulative 50 percent of ownership share changes ownership.
2. [D]evelop a more rational allocation of revenues for the state and local agencies, including cities, counties, special districts, and school districts. The intent of this

restructuring of state and local revenue allocations is to reduce volatility at the state and local level and to provide incentives for economic development and housing."

I. In General (Property Tax)

Change in Ownership. California's system of property taxation under Article XIIIA of the State Constitution (Proposition 13) values property at its 1975 fair market value, with annual increases limited to the rate of inflation or 2%, whichever is less, until the property changes ownership. When a change in ownership occurs, the value of the property for tax purposes is redetermined based on its current market value. The value initially established, or redetermined where appropriate, is referred to as the "base year value." Thereafter, the base year value is subject to annual increases for inflation. This indexed value is referred to as the "factored base year value."

While Proposition 13 provided that a "change in ownership" would trigger reassessment, the phrase was not defined. The Assembly Revenue and Taxation Committee appointed a special task force to recommend the statutory implementation for Proposition 13 including its change in ownership provisions. The task force findings are published in California State Assembly Publication 723, Report of the Task Force on Property Tax Administration, January 22, 1979.

Property Owned by Legal Entities. One issue the task force faced was how to apply the change in ownership provisions of Proposition 13 to property owned by a legal entity. For instance, would a transfer of ownership interests <u>in</u> a legal entity that owns real property be considered transfer of the real property interests and, thus, a change in ownership? The task force considered two alternatives, the "separate entity" theory and the "ultimate control" theory.

- **Separate Entity Theory.** The "separate identity" theory would respect the separate identity of the legal entity. Accordingly, for as long as the legal entity owned the property it would not be reassessed, even if all of the ownership interests in the legal entity had transferred.
- **Ultimate Control Theory.** The "ultimate control" theory would look through the legal entity to determine who held the ownership interests and, thus, who had "ultimate control" of the legal entity. Under this theory, real property owned by the legal entity would be reassessed only when a single holder of ownership interests gained control of the legal entity through the acquisition of a majority of those ownership interests.

The task force recommended that the separate entity theory be adopted, so the change in ownership definitions related to ownership interests in legal entities first placed in statute in 1979 was based on the "separate entity theory." Thereafter, subdivision (c) of Section 64 was added which provided that a change in ownership occurred whenever there was a change in control by a transfer (or transfers) of more than 50% of the total ownership interests to a single person or entity. According to "Implementation of Proposition 13, Volume 1, Property Tax Assessment," prepared by the Assembly Revenue and Taxation Committee, Assembly Publication 748, October 29, 1979, subdivision (c) was added "out of a concern that, given the lower turnover rate of corporate property, mergers or other transfer of majority controlling ownership should result in a reappraisal of the corporation's property – an effort to maintain some parity with the increasing tax burden of residential property statewide, due to more rapid turnover of homes. It was also a trade-off for exempting certain transfers among 100% wholly-owned corporations[1]."

Background

Other bills that would have resulted in more frequent reassessment of property owned by legal entities include AB 1013 (Leonard) in 2001, AB 2288 (Dutra) in 2000, and SB 82 (Kopp, et al) in 1991. Additionally, Proposition 167 in 1992, which addressed a number of tax related items, included a provision to modify the change in ownership definitions related to legal entities. Proposition 167 was not approved by voters.

Homeowners' Percentage of Total Value. The following information, which is annually prepared by the Board's Research and Statistics Section, lists the percentage of gross assessed value from properties receiving the homeowners' exemption compared to total assessed value.

1979-80	33.6%
1980-81	36.3%
1981-82	35.4%
1982-83	34.5%
1983-84	33.6%
1984-85	32.9%
1985-86	32.5%
1986-87	32.4%
1987-88	32.5%
1988-89	32.6%
1989-90	33.1%
1990-91	32.8%
1991-92	33.0%
1992-93	34.2%
1993-94	35.3%
1994-95	36.7%
1995-96	37.6%
1996-97	38.0%
1997-98	37.9%
1998-99	38.1%
1999-2000	38.2%
2000-2001	38.1%

[1] Section 64(b) excludes transfers of ownership interests between affliated corporations."

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the author. The purpose of the property tax provision is to cause more frequent reassessment of nonresidential property to bring its assessed value for property taxation closer to current market value levels.

2. **Legislative findings and declarations.** The bill states the following:

   The Legislature finds and declares that the current tax structure has led to revenue volatility, with tax receipts growing dramatically during good economic times and plummeting during economic downturns. This volatility results from the dynamic nature of California's economy and the increased reliance on personal income tax revenues. The volatility of personal income tax revenues is exacerbated by the increased dependence on personal income tax revenues attributable to capital gains and stock options.

   The Legislature has a strong interest in reducing revenue volatility. A less volatile revenue structure will help the Legislature do each of the following:

   - Maintain funding commitments.
   - Reduce long-term costs by reducing duplicative startup costs.
   - Improve planning.

3. **Amendments**. The May 1 version amends the intent language regarding future amendments to the Revenue and Taxation Code to state that it *may include* the various components listed (i.e., reducing personal income tax rate, broadening the sales and use tax base, reducing the state and local sales and use tax rate, and the property tax change in ownership provisions on nonresidential property) rather than *will include* all of the listed components. The May 1 amendment also added subdivision (d) to include legislative intent to restructure state and local revenue allocations.

4. **This bill would affect nonresidential property owned by legal entities.** Nonresidential property owned by individuals generally would not be affected, since change in ownership laws require a reassessment of the specific percentage of ownership that is transferred (i.e., if 25% changes ownership, then 25% is reassessed). Bills similar to this bill are typically viewed in the context of commercial and industrial properties, but any nonresidential real property owned by a legal entity (partnerships, limited liability corporations, corporations, etc.) would be subject to a revised definition. This could include agricultural property, family farms[2], and small businesses. Excluded would be rental residential property including apartment complexes.

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[2] The parent-child change in ownership exclusion does not apply to transfers of ownership interests in legal entities. Property can be taken out of the legal entity for a direct parent to child transaction.

5. **The Legislative Analyst's Office recently addressed the disparity in the frequency of reassessment of property owned by individuals versus legal entities.** In a report issued last year to the Legislature by the Legislative Analyst's Office, "Reconsidering AB 8: Exploring Alternative Ways to Allocate Property Taxes," related to the frequency of reassessments for residential versus commercial and industrial property, the report noted,

   "For residential property, this acquisition value-based system has some policy merit. Specifically, it (1) encourages stable communities and (2) ensures no sharp increases in taxes from year to year (of particular concern for senior citizen homeowners on fixed incomes). At the same time, however, new homeowners – both first time homebuyers and those relocating - bear a disproportionate share of the residential property tax burden. It is only after a number of years of homeownership that the financial benefits of the acquisition assessment system accrue to homeowners.

   The same benefits of the acquisition value system exist in terms of commercial and industrial property; however, the disadvantages of this policy for businesses in a competitive economy are somewhat troubling. The system can present an economic barrier to entry for new businesses. If a competitor has been in the same location for a number of years, a new business faces higher operating costs. This can discourage the formation of new businesses and reduce competition."

6. **Opponents of more frequent reassessment of nonresidential property, which are properties typically owned by legal entities, note that ultimately the higher property taxes paid by legal entities that own California real estate would result in**:

   - higher cost of goods and services,
   - loss of business growth to other states and countries,
   - reduction of California competitiveness,
   - decrease in profits to owners and investors including retirees,
   - lower wages for employees of legal entities,
   - increase in the size of government, and
   - increase in government employee salaries

7. **How would the change in definition cause more frequent reassessments with respect to nonresidential property owned by legal entities?** Under existing law, when ownership interests in a legal entity are transferred, the real property owned by that legal entity does not undergo a change in ownership if **no one person or legal entity acquires more than 50% of the ownership interests in the legal entity,** thereby causing a "change in control." Thus, the ownership interests in a

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However, there is a one million dollar cap on the value of property that may be transferred without reassessment.

legal entity may undergo a complete turnover in a series of transfers, and, if no single person or legal entity obtains an interest exceeding 50%, there is no change in ownership of the real property owned by the legal entity. As a result, it is possible that real property owned by a legal entity since 1975 has never undergone a change in ownership and been reassessed and may never be reassessed as long as the current definitions hold. Under this bill, as soon as individually or **cumulatively more than 50% of the ownership interests in the legal entity are sold or transferred,** then all the real property owned by the legal entity would undergo a change in ownership regardless of whether a single person or legal entity obtains more than 50%. Thus under this bill, rather than tracking ownership interests to determine whether they are held by a single controlling owner, the transfers of ownership interests in legal entities that own California real estate would be tracked until those transfers exceeded 50%.

8. **How often would nonresidential property owned by legal entities be reassessed?** In practical application, most real property owned by a corporation whose stock is owned and traded by the public would likely be frequently reassessed to current market values because of the high turnover of stock in these companies. It is theoretically possible that the real property owned by a corporation could be reassessed once a year or more. With respect to nonresidential property owned by privately held corporations and partnerships, there would be less frequent reassessment of these properties, since there would generally be fewer turnovers of ownership interests.

9. **Property taxes paid by legal entities generally increase over time.** Businesses, unlike homeowners, also pay property taxes on their personal property holdings. Their personal property is assessed every year at its current market value. Additionally, as businesses grow and expand, any real property that a legal entity newly constructs or acquires is reassessed to current market value. Further, mergers and takeovers of corporations can result in reassessment triggers.

10. **The Administrative Workload.** County assessors' offices are not staffed at levels to handle the increase in real estate appraisal workload that this bill would create. It would likely take many years to determine which legal entities have had a change in ownership and to then appraise the nonresidential properties owned by the legal entity.

    Properties owned by legal entities are generally the most complex type of property to appraise. In addition, evaluating whether a legal entity has had more than a 50% turnover in ownership interests would likely require a substantial commitment of resources, and would presumably lead to an increase in the number of assessment appeals and lawsuits.

    Either the Legal Entity Ownership Program (LEOP) division of the Board of Equalization or county assessors would need to develop a comprehensive set of written procedures for identifying and tracking the existence of all legal entities (corporations, partnerships, and limited liability corporations etc) in all counties each year.

The Board and the Franchise Tax Board (via a question on the income tax return) currently have certain roles in identifying, tracking, and transmitting to counties changes in control and changes in ownership of legal entities that own property. This would likely be insufficient under the proposed new definitions.

11. **This bill represents a major overhaul of the property tax administration system as it relates to property owned by legal entities**. This is a fundamental policy issue with substantial administrative and implementation issues that would require resolution. Prior analyses of this concept for Senate Bill 82 in 1991 and Proposition 167 in 1992 noted the numerous technical issues with periodic reappraisal of legal entities and the special difficulties of tracking stock ownership interests. If this policy change is desired by the Legislature, then it may be appropriate to delay the implementation and create a task force with members of industry, the Board, assessors, the legislature, academics, and stock industry experts, etc. to determine and resolve these implementation issues.

COST ESTIMATE

The administrative costs to the Board depend on its role in tracking ownership interests in legal entities. No estimates of the costs can be determined without further clarification of the Board's role.

REVENUE ESTIMATE

Background, Methodology, and Assumptions

This bill would state legislative intent to enacts laws that would require property owned by legal entities to be reassessed whenever more than 50 percent of the ownership interests in the legal entity is transferred either individually or cumulatively.

If these changes were made, it would necessitate that real property owned by legal entities be reassessed more often than it is under current law. This would result in an increase in assessed value and an increase in property tax revenue.

It is not possible to estimate the increase in property tax revenues with any degree of certainty. We do not know how much property is owned in California by legal entities that would be affected by this proposal. We do not know the current assessed value of this property nor do we know the actual market value of this property. We have no information on how often these properties would be reassessed based on the change in ownership provisions of this proposal.

At best, we can attempt to estimate what the revenue effect would be if all of the property that might potentially be subject to this proposal were to be reassessed at its actual market value rather than at the current assessed value. One of the factors that hampers us from making this estimate is a lack of information regarding the breakdown of current assessed values by property type. In 1997, we attempted to estimate the breakdown of the assessed value of locally assessed real property by property type. This breakdown was based on information from the U.S. Department of Commerce's publication *Census of Governments*. This information is somewhat outdated, but more current information is not available. This breakdown was as follows:

Property Type	1996-97 Assessed Value (in billions)
Single family residential	$ 920.9
Multiple family residential	187.5
Agricultural	71.2
Commercial/Industrial	442.0
Vacant Lots/Other	98.8
Total	$1,720.4

If we assume the same percentage breakdown would apply to the assessed values on the 2000-01 property tax rolls, the breakdown would be:

Property Type	2000-01 Assessed Value (in billions)
Single family residential	$1,152.1
Multiple family residential	234.6
Agricultural	89.1
Commercial/Industrial	553.0
Vacant Lots/Other	123.6
Total	$2,152.4

This proposal would not affect residential property. While there would be some agricultural property that may be owned by legal entities, the restrictions on this property would probably not cause a great deal of reassessment (i.e., property under the Williamson Act). The vacant land/other category is a hodgepodge, a sizeable portion of which is land in transition, i.e., about to be developed into residential or commercial/industrial. We will assume that half of this category is owned by legal entities that would be subject to the proposed re-definition of change in ownership. For purposes of this estimate, we will assume that all commercial/industrial property would be affected. Including all of this property will overstate the affect since we know that a portion of this amount would not be affected by the proposal. Therefore, the following amount should be treated as a cap on the potential revenue effect of the concept. Based on these assumptions, we can estimate the amount of property potentially affected as follows:

Property Type	2000-01 Assessed Value (in billions)
Commercial/Industrial	553.0
Vacant Lots/Other	61.8
Total	$ 614.8

The next step is to estimate the market value of this property. The Board does a study each year to determine the effective assessment level for commercial/industrial property in order to determine the assessment level for rail transportation property. The latest study, completed in May 2000 was based on information from the 1998-99 assessment roll. That study found that the effective assessment level for locally assessed real commercial/industrial property was 71.95%. If we apply this ratio to the assessed value estimated above, we calculate the market value of this property to be $854.5 billion, an increase of $239.7 billion. The property tax revenue at 1% tax rate on this increase in value would be $2.4 billion. **However**, this figure is, as noted above, the **maximum** amount of increased property tax revenue that could be expected from this proposal. It is clear that the actual amount would be less than this, as not all of the property included in the above analysis would be subject to the concept of this bill, but how much less is impossible to determine. It also should be noted that whatever the amount might be, it will be added over a number of years, as the various properties are reassessed based on the proposed conceptual changes to the change in ownership provisions.

Revenue Summary

As legislative intent language, this bill has no revenue impact. With respect to the revenue implications of the proposed concept, it is not possible to determine the revenue impact as the information regarding the number of properties affected, the current assessed value of these properties, the actual market value of these properties or the turnover rate based on the change in ownership provisions of the bill is not available. The analysis presented above is an attempt to estimate the order of magnitude of potential revenue gain of the proposed concept.

II. In General (Sales and Use Tax)

Broadening the base/lowering the rate. The shift in consumer expenditures from the purchase of goods to the purchases of services continues to raise concerns about the long-term vitality of state retail sales taxes which traditionally are applied primarily to the sale of tangible personal property. The sales tax in California was enacted during the 1930's when services accounted for a small portion of overall economic activity. With high unemployment rates and jobs hard to come by, few governors or legislators were willing to be accused of taxing labor services and further burdening the laborers. Thus, the initial sales tax enactment exempted nearly all forms of service.

Since then, however, the U.S. economy has shifted away from the manufacture and sale of tangible personal property to activity based on service-related transactions. In 1980-81, the California sales tax accounted for 37% of General Fund revenue; today, it provides only 29.5%. As the economy becomes service oriented, rather than production oriented, services have been considered to be an area to turn to broaden the state's tax base.

Allocation of State and Local Revenues. Prior to Proposition 13, each local government with taxing powers (counties, cities, schools, and special districts, etc.) could levy a property tax on the property located within its boundaries. Each jurisdiction determined its tax rate independently (within certain statutory restrictions) and the statewide average tax rate prior to Proposition 13, under this system, was 2.67 percent. After Proposition 13, the property tax rate was limited to a maximum of one percent of a property's assessed value. Because Proposition 13 reduced the revenues that would be received from property taxes from any particular development (industrial, commercial, or residential), local jurisdictions began to pay even more attention to the fiscal outcomes of land use decisions, and those uses that generated revenues in addition to property taxes have been elevated in importance.

The decision by local governments to utilize land for retail sales in order to generate sales tax revenues is one example of the fiscalization of land use. Local governments have engaged in numerous activities to encourage retail activity in their jurisdiction, such as zoning excessively for retail, providing sales tax rebates to retailers who locate in their jurisdiction, waiving developer fees, and expediting the permit process.

Background

Broadening the base/lowering the rate. The taxation of services as a way of broadening the tax base and lowering the rate isn't new. Many states already tax services to some degree. New Mexico has taxed all goods and services since the adoption of its gross receipts tax in 1934.

In California, as early as 1969, then Governor Reagan recommended the sales tax be extended to selected services – primarily the repair of certain property and the cleaning, installing and maintaining of certain personal property. AB 2046 passed the

Assembly Revenue and Taxation Committee that year, but was not enacted into law. During the 1990-91 budget crisis, considerable attention was given to the concept of broadening the sales tax base by taxing selected services. However, another approach was taken to address the budget shortfall – an increase in the sales and use tax rate and the repeal of various sales and use tax exemptions.

Allocation of State and Local Revenues. During this session, Assembly Bill 680 (Steinberg) contains provisions pertaining to local sales and use tax allocation. AB 680 would change the allocation method of the one percent local sales tax in El Dorado, Placer, Sacramento, Sutter, Yolo, and Yuba counties. Another measure this year, AB 2878 (Wiggins), more broadly addresses this issue by modifying the property tax allocation to a city or county, and specifying that a city may not impose a sales and use tax rate in excess of 0.85% except under specified circumstances. This measure would also prohibit the state from transferring money from the General Fund to cities and counties to fund vehicle license fee offsets.

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the author. Its purpose is to express legislative findings that the volatility of our current revenue structure has caused substantial difficulties in recent years and that some ways that could assist in making it more stable include: broadening the sales tax base and reducing the tax rates, and providing a more allocation of local taxes to provide incentives for economic development and housing.

2. **Arguments in favor of taxing selected services.**

   A) In general, the taxation of services could being in greatly increased revenues and/or allow a reduction in the current sales tax rate.

   B) Taxation of some services could make the sales tax somewhat less regressive, since expenditures on many services would tend to rise as income rises.

   C) One continuing problem area in administering the current sales and use tax law relates to determining the true object of the contract which includes both professional services and the transfer of tangible personal property. This is especially true in business, accounting and engineering services. By imposing sales tax on these services, no further distinction would be necessary.

   D) There is no economic or social policy reason to justify a more favored tax treatment for the purchase of services than for the purchase of tangible personal property. Expenditures of services constitute consumer expenditures just as do purchases of goods. A haircut, a symphony or a gardener satisfy personal desires in the same manner as a bottle of shampoo, a CD, or a lawn mower.

   E) Taxation of specified services could make the sales tax more elastic, that is, to grow faster in revenue than the rate of economic growth.

3. **Arguments against taxing services.**

A) One of the primary arguments against taxing services is the distortion of business competition by the tax. For example, many businesses hire other firms or independent contractors to perform such services as cleaning, accounting, and legal services. Larger businesses, on the other hand, may have staff on the payroll to perform these same services. A tax on services could have a negative impact on smaller businesses which contracts for services but not on a large business with in-house staff.

B) A tax on certain services would be viewed as poor social policy and could increase the regressivity of the tax to extend the tax to certain services, such as medical services. Placing a tax on a legal service necessary to obtain justice may be inappropriate. Taxing repair services may be regressive in that older model cars and other items – more likely owned by lower income persons – generally have greater repair expenses.

C) A tax on certain services provided to interstate businesses may encourage businesses to shift the purchase of these services out-of-state.

D) From an administrative viewpoint, a tax policy that causes problems for taxpayers or difficulties for the Board is a tax policy that will fail. If the Board cannot audit to ensure accurate compliance, then voluntary compliance will vanish. If the costs of compliance are excessive, taxpayers will not comply. Tax law that relies on arbitrary or illogical distinctions increases administrative costs and decreases compliance. To the extent that the types of services being taxed are not clearly defined, administration of the tax can be very difficult and costly.

E) A major administrative burden with a tax on services would be identifying and registering the many new business entities and processing a vastly increased volume of tax returns. Proportional expenses for collection and audit will increase.

COST ESTIMATE

An estimate of costs will be deferred pending more specificity on the method in which the tax base is broadened, or the way in which the local tax structure is modified.

REVENUE ESTIMATE

As legislative intent language, this bill has no revenue impact. An estimate of the revenue implications of the proposed concept will be deferred pending more specificity on the method in which the tax base is broadened, or the way in which the local tax structure is modified.

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